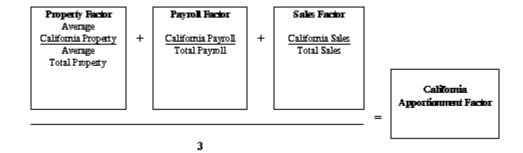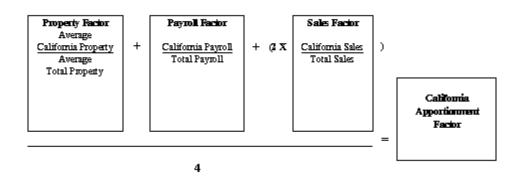_____

7000 APPORTIONMENT FORMULA

Apportionment is the process by which business income is divided between taxing jurisdictions. The apportionment formula calculates the percentage of the property, payroll and sales of the unitary business, which are attributable to California. The total business income of the unitary business is multiplied by this percentage to derive the amount of business income apportioned to this state.

For purposes of the apportionment formula, the property factor generally includes all real and tangible personal property owned or rented and used by the taxpayer during the taxable year, and the payroll factor includes all forms of compensation paid to employees. These factors are intended to reflect the capital investment and labor activities that generate income. The sales factor generally includes all gross receipts from the sale of tangible and intangible property, and is intended to recognize the contribution of the market state towards the production of income.

Prior to 1993, California followed the model UDITPA formula (see MATM 0500). This was a three-factor formula that gave equal weight to the property, payroll and sales of the business. This formula operated as follows:

For taxable years beginning on or after January 1, 1993, the apportionment formula has been modified to double-weight the sales factor. Giving more weight to the locations where the taxpayer makes its sales provides an incentive for companies to locate or expand in California by reducing taxes for companies with headquarters or major production facilities within the state. Conversely, the double weighting increases the tax burden of those companies that exploit California markets without locating productive capacity within the state. The apportionment formula is now computed as follows:

_____

$$\frac{\left[\begin{array}{c}\textbf{Property Factor}\\ \text{Average}\\ \text{California Property}\\ \hline \text{Average}\\ \text{Total Property}\end{array}\right] + \left[\begin{array}{c}\textbf{Payroll Factor}\\ \\ \dfrac{\text{California Payroll}}{\text{Total Payroll}}\end{array}\right] + \left(2 \times \left[\begin{array}{c}\textbf{Sales Factor}\\ \\ \dfrac{\text{California Sales}}{\text{Total Sales}}\end{array}\right]\right)}{4} = \boxed{\begin{array}{c}\textbf{California}\\ \textbf{Apportionment}\\ \textbf{Factor}\end{array}}$$

There are certain classes of taxpayers (such as those in extractive, agricultural, savings and loan, and bank and financial industries) for whom the double-weighted sales factor does not apply. Those taxpayers will continue to use a single-weighted formula. For a discussion of these exceptions, see MATM 7005.

The above formulas calculate the amount of business income of the unitary group that is apportioned to California. The calculation of each taxpayer corporation's relative share of the California income is covered in MATM 7900 (*Intrastate Apportionment*).

In some cases, the standard apportionment formula will not fairly represent the taxpayer's activity within the state. CCR §25137 set forth apportionment procedures for certain industries and types of transactions that do not lend themselves to apportionment under the standard rules. These special rules are discussed in MATM 7700 – MATM 7815 along with other procedures that have been developed for dealing with some of the more common apportionment problems.

Taxpayers occasionally argue that the apportionment formula is inherently distortive because the wage rates, property values and sales prices in many countries are lower than those in California. Their position is that although $1 of capital or labor in many countries has more earnings potential than $1 of capital or labor in the U.S., the higher California values in the factors pull the income into this state. The U.S. Supreme Court has recognized that this potential for distortion exists, but has nonetheless validated California's system as a fair apportionment scheme on the basis that some degree of distortion is to be expected in any taxation system (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App.3d 988 (1981)). The mere showing that property, payroll or sales in California are higher than in other jurisdictions will therefore not be sufficient to justify departure from the standard formula. See also *Appeal of Kikkoman International, Inc.,* Cal. St. Bd. of Equal., June 29, 1982; *Appeal of Evergreen Marine Corporation (Calif.) Ltd.,* Cal. St. Bd. of Equal., March 4, 1986.

In unusual situations where alternative apportionment procedures have not been developed and where application of the standard formula will produce incongruous results, the taxpayer may request

_____

permission for (or FTB may require) use of another method for allocating and apportioning its income. Such other methods may include separate accounting, exclusion of one of the factors, or the inclusion of an additional factor. The authority for use of a special apportionment method is found in CCR §25137, and is generally only invoked in exceptional cases. Auditors should consult with their supervisors if they come across a case, which may require development of a special formula not described in the CCR §25137, or in this manual. Procedures for handling a taxpayer's §25137 petition are covered in the §25137 Procedure Manual.

Reviewed: December 2002

_____

7005 *EXCEPTIONS TO THE DOUBLE-WEIGHTED SALES FACTOR FORMULA*

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been modified to double-weight the sales factor. As an exception to this rule, taxpayers that derive more than 50% of their gross business receipts from conducting a "qualified business activity" will continue to use the single-weighted apportionment formula (R&TC §25128(b).). The following "qualified business activities" are described in R&TC §25128(c)(2) through (5):

An extractive or agricultural business activity (these exceptions apply for all taxable years beginning on or after January 1, 1993). On July 9, 1999, CCR §25128, CCR §25128-1 and CCR §25128-2 were finalized. These regulations provide guidelines for determining when a taxpayer qualifies as an extractive or agricultural activity for purposes of the single weighted sales factor.

A savings and loan activity (this exception applies for taxable years beginning on or after January 1, 1994).
A banking or financial business activity (this exception applies for taxable years beginning on or after January 1, 1996).

The "more than 50%" test for determining whether a taxpayer is in a qualified business activity applies to the combined gross business receipts of the unitary group. Once it is determined that a combined unitary group meets this test, the entire business income of the group will be apportioned using a single-weighted sales factor formula. (R&TC §25128(d)(7).) This distinction is important because even though individual members of the group may not be involved in qualified business activities, they will be subject to the single-weighted sales factor if the group as a whole meets the test.

For 1993 only, the language of R&TC §25128 accomplished the group application of these provisions by defining the term "taxpayer" to refer to all of the corporations included in the combined report. As explained in FTB Legal Ruling 94-1, that definition applies only for purposes of that provision, and has no application to other UDITPA provisions. In 1994, R&TC §25128 was revised to provide for the group application without reference to the term "taxpayer."

FTB Legal Ruling 96-1 was issued to clarify that if divisions of a single corporation conduct more than one trade or business, and those businesses are not unitary with each other, then the "more than 50% test" will apply separately for each line of business. Furthermore, if a corporation is a partner in a partnership, but is not unitary with that partnership, then the "more than 50% test" will be applied at the partnership level.

Reviewed: September 2003